

Office of Chief Counsel
Internal Revenue Service

memorandum

CC:NER:BRK:TL-N-2002-00
TKerrigan

date:

to: Chief, Examination Division
Attention: Manager Group 1437 - Large Case Group
E:E:F:1437

from: District Counsel
Brooklyn CC:NER:BRK

subject: [REDACTED] - Research & Experimentation Deduction
Taxable years: [REDACTED]
U.I.L. No. 0174.00-00

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This memorandum is in response to your request for advice from Revenue Agent Alan Seinfeld of your staff concerning I.R.C. § 174 research and experimentation deductions claimed by the taxpayer for the taxable years [REDACTED] and [REDACTED].

FACTS

The facts, as we understand them to be, are as follows: [REDACTED]
[REDACTED] is a wholly-owned U.S. subsidiary of [REDACTED] a company located in the United Kingdom, and one of the [REDACTED] mining companies with [REDACTED] interests in mining metals and industrial minerals located in [REDACTED] [REDACTED] and [REDACTED]'s mining and metal interests are in [REDACTED] [REDACTED] and [REDACTED] [REDACTED], a wholly owned subsidiary of [REDACTED] owns and operates the [REDACTED] mine located near [REDACTED] approximately [REDACTED] [REDACTED]'s existing smelter and refinery were placed in service in the [REDACTED].

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In [REDACTED], [REDACTED] hired [REDACTED] to work on [REDACTED]'s Smelter and Refinery Modernization Project. [REDACTED] prepared several studies that evaluated various proposals to improve [REDACTED]'s smelting and refinery operations. [REDACTED] recommended two possible alternatives for modernization of the facility. The first option involved the upgrade and rehabilitation of the existing [REDACTED] smelter to increase the capacity of the smelter. The second option involved the construction of a new [REDACTED] smelter constructed on a site adjacent to the existing smelter. This new smelter would incorporate the latest [REDACTED] technology, utilize a new type of [REDACTED] and increase production capacity.

In [REDACTED], [REDACTED] commissioned [REDACTED] to prepare additional studies addressing the technical and financial aspects of the second proposal for purposes of making a determination on the viability of the project. Based on the results of [REDACTED]'s technology survey of three alternative smelter technologies, [REDACTED] hired [REDACTED] to confirm the suitability of [REDACTED]'s [REDACTED] technology for use by [REDACTED]. These tests were conducted in [REDACTED]'s facilities in Finland during [REDACTED] and [REDACTED]. Based on these studies and tests, [REDACTED] initiated basic process engineering for [REDACTED] and converting to modernize its smelting process. In addition, two engineering and construction contracts were awarded in [REDACTED]. The development of the smelting process was awarded to a joint venture between [REDACTED]. Construction on the project began in the [REDACTED] of [REDACTED]. Design and construction of the modernized smelter were completed in [REDACTED]. In [REDACTED] of [REDACTED], the new smelter and its various components were placed in service.

The taxpayer initially capitalized the expenditures related to this project. The taxpayer then contracted [REDACTED] who interviewed [REDACTED] financial and technical personnel to identify activities and expenditures that might potentially qualify as research and experimentation expenses instead of capital expenses. Based on these interviews, [REDACTED] and [REDACTED] reviewed reports generated by [REDACTED]'s Cost Engineering and Forecasting Reporting System, which listed all expenditures by activity. [REDACTED] and [REDACTED] used this information to identify certain costs that they believed qualified as research and experimentation expenditures. [REDACTED] prepared summary documentation binders to organize this information.

The summary reports provided by [REDACTED] identify a specific phase of the project by tax year and provide costs by facility number and name. The costs are broken down into four categories: (1) direct costs, (2) indirect costs, (3) owner's cost, and (4) smelter modernization study. [REDACTED] lists the total project costs

in addition to the costs that they have determined to qualify as research and experimentation expenditures.

For the [REDACTED] taxable year, the taxpayer filed a Form 3115, Application for Change in Accounting Method, with respect to the accounting treatment of the research and experimentation expenses at issue. The taxpayer described the proposed change as follows:

The taxpayer proposes to change its method of accounting for Section 263A costs. In prior taxable years, the taxpayer has capitalized or otherwise accounted for Section 174 research and experimental expenses in a manner that they are captured and incorporated in the taxpayer's Section 263A calculation. The taxpayer proposes to properly deduct Section 174 costs in accordance with the provisions under Section 174. As Section 174 is exempt from the provisions of Section 263A, an accounting method change is required and is being made in accordance with the procedures set forth in Rev. Proc. 94-49.

The proposed accounting change resulted in R&E deductions in the amounts of \$ [REDACTED] and \$ [REDACTED] in [REDACTED] and [REDACTED], respectively and I.R.C. § 481 adjustments in the amounts of \$ [REDACTED] and \$ [REDACTED] in [REDACTED] and [REDACTED], respectively.

ISSUE

Whether the costs identified by taxpayer, under the facts described above, are deductible as research and experimental expenditures under I.R.C. § 174.

LEGAL ANALYSIS

I.R.C. § 174(a) provides that a taxpayer may treat research or experimental expenditures that are paid or incurred by the taxpayer during the taxable year in connection with taxpayer's trade or business as expenses that are not chargeable to capital account. The expenditures so treated are allowed as a deduction. Treas. Reg. § 1.174-2(a)(1) provides that the term "research or experimental expenditures" means expenditures incurred in connection with the taxpayer's trade or business which represent research and development costs in the experimental or laboratory sense. In 1994, the Service amended the treasury regulations to clarify the definition of "research or experimental expenditure". As clarified in the amendments, expenditures represent research and development costs in the experimental or laboratory sense if they are for activities intended to discover information that would eliminate uncertainty concerning the development or improvement of a product. Uncertainty exists if the information

available to the taxpayer does not establish the capability or method for developing or improving the product or the appropriate design of the product. Whether expenditures qualify as research or experimental expenditures depends on the nature of the activity to which the expenditures relate, not the nature of the product or improvement being developed or the level of technological advancement the product or improvement represents. The uncertainty test, as reflected in the final amendments, reflects the dual purpose of I.R.C. § 174 to encourage research, as well as to avoid difficult tax accounting questions that would arise in the absence of special tax accounting rules. See Treasury Decision 8562, Research or experimental expenditures: Definition Reasonable requirement (September 30, 1994); 59 Fed. Reg. 50159 (October 3, 1994).

Treas. Reg. § 1.174-2(a)(2) provides that the term "product" includes any pilot model, process, formula, invention, technique, patent, or similar property, and includes products to be used by the taxpayer in its trade or business as well as products to be held for sale, lease, or license. Treas. Reg. § 1.174-2(a)(3) provides that the term "research or experimental expenditures" does not include expenditures for (i) the ordinary testing or inspection of materials or products for quality control, (ii) efficiency surveys, (iii) management studies, (iv) consumer surveys, (v) advertising or promotions, (vi) the acquisition of another's patent, model, production or process, or (vii) research in connection with literary, historical, or similar projects. Treas. Reg. § 1.174-2(a)(4) provides that, for purposes of paragraph (a)(3)(i), testing or inspection to determine whether particular units of materials or products conform to specified parameters is quality control testing. However, quality control testing does not include testing to determine if the design of the product is appropriate.

The taxpayer's primary argument is that their new smelter was the most modern and efficient smelter ever constructed. The taxpayer asserts that the proposed project goal was to complete the design, engineering and development of a smelter that combines the [REDACTED] with complex instrumentation and computerized control systems. [REDACTED] the taxpayer maintains that there were significant technological uncertainties.

In this case, there is no dispute that the expenses at issue were incurred by the taxpayer in carrying on its trade or business. The taxpayer engaged in engineering design activities to determine the capability or method for developing or improving their smelting technology, as well as the appropriate design of the new smelter. The project undertaken by taxpayer involved the

engineering and development of a state of the art smelter that incorporated the most recent [REDACTED] technology. Therefore, it would appear that at least some part of the expenses represent research and experimental expenditures.^{1/} The only issue is whether the taxpayer's method of reconstructing the expenses that qualify as I.R.C. § 174 expenses accurately reflects the deductible expenses.

For the reasons discussed below, we believe that amounts claimed as I.R.C. § 174 expenses may be overstated and the issue requires further factual development. First, the taxpayer's methodology for determining the qualifying expenses is suspect. The expenses were identified after the fact based on interviews conducted by [REDACTED] consultants of [REDACTED]'s staff. It is our understanding that there are no contemporaneous records or notes from these interviews. Second, the documentation offered fails to identify the specific activities that were undertaken to eliminate specific technological or engineering uncertainties. This information is necessary for the Service's engineers to properly evaluate the taxpayer's broad assertion that solutions to these problems were not readily apparent to engineering professionals familiar with the basic stock of commonly used knowledge and techniques in this area of expertise. We note that although the new smelter project incorporated the latest technology, some components and process steps utilized pre-existing technology. Therefore, some of the claimed activities may simply represent the application of established mechanical and electrical engineering principles. Third, the supporting narratives only provide a superficial description of the alleged technological problems that arose during the project. Fourth, the taxpayer has not made available the underlying source documents and accounting records relied upon for its calculation of qualified expenses. The taxpayer has thus far been unable to even verify the project total costs from which the qualified expenses were derived.

CONCLUSION

^{1/} We note that the 1993 Proposed Treas. Reg. §1.174-2(a)(1) contained a narrower uncertainty test. Under the proposed regulation, uncertainty existed if information reasonably available to the taxpayer does not establish the capability or method for developing or improving the product. In the explanation of provisions for the 1994 regulations, the Service addressed the concerns of commentators by providing in the amended regulation that a taxpayer's knowledge that a product development project will be successful does not preclude the process of determining the appropriate design of the product from qualifying as research. See Treasury Decision 8562, Research or experimental expenditures: Definition Reasonable requirement (September 30, 1994)

Based on the above, we believe that this issue requires further factual development to determine the appropriate amount of the taxpayer's I.R.C. § 174 research or experimentation expenses. It is our understanding that there are two outstanding information document requests relating to the methodology used by the taxpayer to determine the qualified expenses. We believe that a reasonable approach under the facts and circumstances of this case would be to select a number of cost centers for further examination. The purpose of these examinations would be two-fold: (1) to identify that specific research or experimentation performed and (2) to verify that the accounting allocation properly captures only those costs incurred with respect those identified activities.

This opinion is based upon the facts set forth herein. It might change if the facts are determined to be incorrect. If the facts are determined to be incorrect, this opinion should not be relied upon. You should be aware that, under routine procedures, which have been established for opinions of this type, we have referred this memorandum to the Office of Chief Counsel for review. That review might result in modifications to the conclusions herein. We will inform you of the result of the review as soon as we hear from that office. In the meantime, the conclusions reached in this opinion should be considered to be only preliminary.

If you have any questions or require further assistance, please contact Thomas Kerrigan at (516) 688-1742.

JODY TANCER
Acting District Counsel